Serial Default and Its Remedies

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1. Introduction

There is a high probability that sometime within the next few years, at least two or three of today's highly leveraged emerging markets are going to suffer another traumatic debt crisis. There will be a witch hunt for culprits, led by various pundits who will, perhaps, point to the injustices of globalization, the lack of democracy in the international financial institutions, or the technical problems in the "international financial architecture." It is hard to guess exactly what the debt crisis "flavor of the decade" will be, but we will surely see one. And we can be equally sure that many if not most of these clever pundits will pronounce their theories in blithe ignorance of the five-hundred-year (plus) history of international debt problems. If, for example, they attribute the problem entirely to the World Bank and International Monetary Fund, will they acknowledge that the seemingly endless cycle of booms and busts in emerging markets has been going on for nearly two hundred years and that many of today's rich countries experienced similar cycles in earlier centuries? Will they remember that the vast majority of historical defaults took place well before the terms "globalization" and "financial architecture" had been coined; well before the sixty-year-old International Monetary Fund or World Bank existed; and in times when there was no G7? (And had there been one, it would certainly not have included the United States or Japan.)

Collective amnesia is not restricted to periods of crisis. The symptoms are, if anything, worse during the booms between the crises. During each cycle of new lending, we can find many pundits declaring, "This time it's different." (Indeed, sometimes there are the same pundits who

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later decide they knew it all along.) Take today, for example. "This time is different" is the current theme song throughout today's international capital markets. With interest rates in rich countries at near record lows, funds in search of higher yields have sharply compressed risk premiums on emerging market debt. We read that "policies are better" (except in countries like Venezuala, where they are worse), "exchange rates are more flexible" (except in regions like Asia, where they are more rigid than ever), "governments are being more prudent in their borrowing" (except they seem to borrow more!), "commodity export prices are high" (except what goes up can come down).

The main theme of this article is that debt cycles are deeply entrenched in the process of development, and one must be careful about trusting magic elixirs that purport to finesse the problem. The nascent political and economic institutions of middle-income countries often face extremely high degrees of economic uncertainty, not least stemming from the extraordinary volatility of world commodity and agricultural prices. At the same time many of these countries have exhausted autarkic growth strategies and find themselves desperately needing to deepen financial markets in order to allocate scarce saving and expand growth efficiently. But this process of deepening—often associated with increased international capital market integration—almost invariably exposes them to heightened risks. And, unfortunately, once a country suffers one bout of default, its institutions and markets become weaker and more vulnerable to further debt problems, a phenomenon Reinhart, Rogoff, and Savastano (2003) term "debt intolerance." In turn, debt crises have dire implications for many critical issues like health care, education, the environment, and policy security, not to mention economic stability.

How can countries emerge? According to our reading of the historical evidence, the most durable and reliable way a country can graduate from debt intolerance is to achieve and maintain low levels of both government debt (external and internal) and overall external debt (owed by both governments and the private sector). Countries that have escaped a history of serial default or countries that have cured their debt intolerance usually succeed by following this path. Curiously, many supposed "fixes" to the international financial architecture go 180 degrees in the opposite direction. They aim to change bankruptcy laws—to find new forms of debt—so that countries can issue more rather than less debt. We argue that this is a naïve and dangerous read of history.

Section 2 of the article describes the recurring cycle of capital flows, pointing to why pundits have been convinced time and again that "this

time it's different." Section 3 discusses the concept of debt intolerance. Section 4 ponders remedies for debt intolerance and serial default. And Section 5 concludes.

2. Capital Flow Cycles and the Syndrome of "This Time Is Different"

Cycles in capital flows to emerging markets have now been with us for nearly two hundred years. The players (both borrowers and lenders) may change, but the cyclical patterns have remained singularly similar through time. When interest rates are low and liquidity is ample, global investors become dissatisfied with the returns they can get by concentrating all their assets in global financial centers. Stretching for yield, they seek higher returns elsewhere.[1] During these flush periods it is easier for governments in emerging markets to borrow from abroad—and borrow they do. Unfortunately, however, history has shown that for many of these countries, to borrow is to brook default.

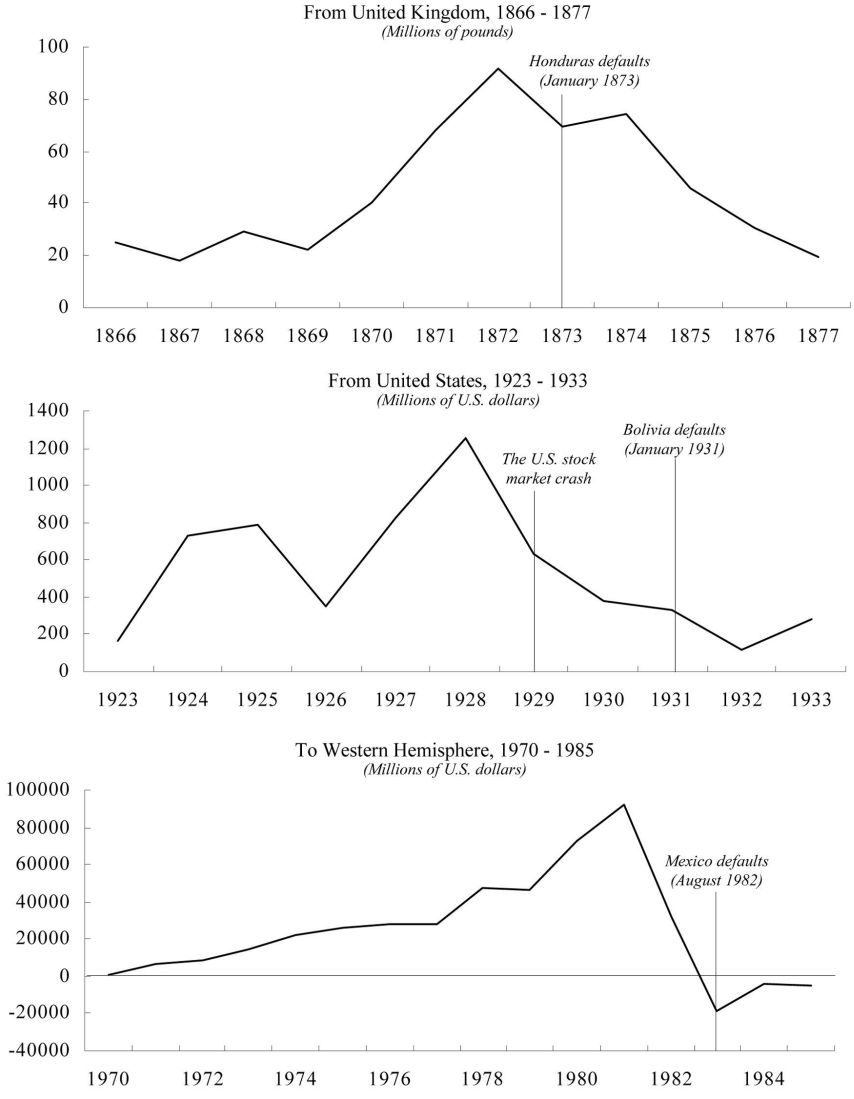
For example, a pattern of borrowing followed by crisis is evident in the string of defaults during 1826–28 in Latin America that came on the heels of the first wave of massive capital flows from Britain into Latin America in 1822–25. These capital flows included not only official borrowing by the newly independent governments for fiscal and nation-building purposes but also substantial equity capital to finance prospective silver and gold mines.[2] A second wave of capital flows from Britain came during the 1850s and 1860s. Investors evidentally decided that "this time it's different" because loans largely financed railroads aimed at paving the way toward modernization. The cycle ended with the crisis of 1873 (Figure 1). The next wave of capital flows into emerging markets coincided with the shift of the financial epicenter of the world from London to New York. Among Latin American countries, the borrowing binge of 1925–28 was explained in large part by "development" loans—the new "this time it's different" fashion—as governments saw an opportunity to finance new public works and urban modernization projects with "cheap" money from New York. Capital flows peaked in 1928, the year before the U.S. stock market crash ushered in financial and currency crises around the world and eventually an international debt crisis during 1929–33 (Figure 1).

[1] For a discussion of these issues in the present context, see Rogoff (2004); and for how these cycles are associated with contagious currency crises, see Kaminsky, Reinhart, and Vegh (2003).

[2] See Centeno (2002) and Marichal (1989).

FIGURE 1

Net Capital Flows



Sources: IMF, *World Economic Outlook*, Stone, Irving, *The global export of capital from Great Britain, 1865-1914*, New York, N.Y.: St. Martin's Press, 1999, and United Nations, *International Capital Movements during the Inter-War Period*, New York, N.Y.: United Nations, 1949.

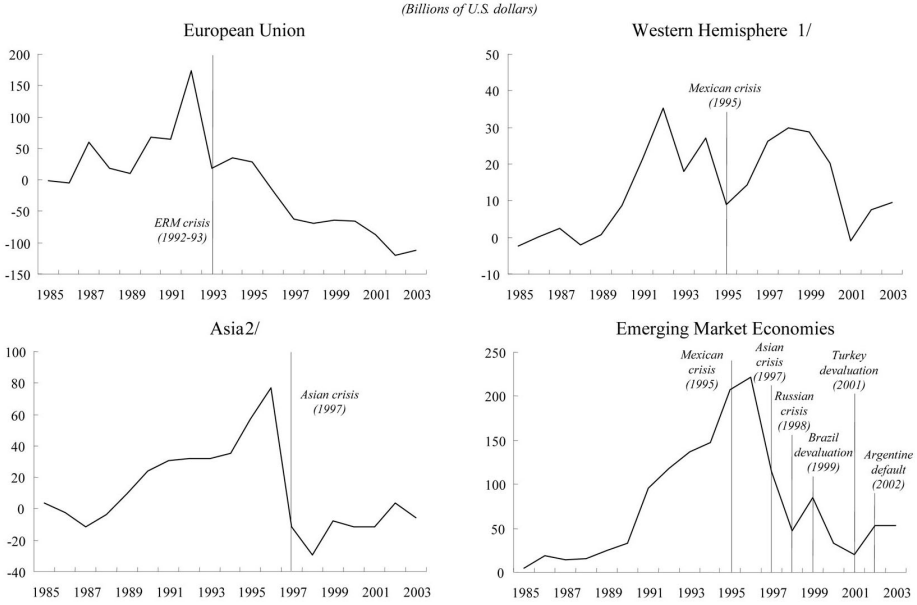
Among the more recent episodes, beginning with the events leading up to the debt crisis of the 1980s, a surge in capital flow cycle played its predictable role in precipitating an eventual crash. In the late 1970s soaring commodity prices fueled by the newly acquired power of OPEC and high inflation in the advanced economies made "recycling" funds to emerging markets seem particularly attractive. Policymakers were convinced, however, that "this time it's definitely going to be different" because they expected oil and other primary commodity prices to continue to trend higher, making emerging market commodity exporters richer and richer. Low, sometimes negative real interest rates and weak loan demand in the United States further convinced many U.S. banks to lend to Latin America and other emerging markets—and lend they did. Capital flows, by way of bank lending, surged (Figure 2). Unfortunately, albeit inevitably, by the early 1980s the situation had changed significantly for the worse, and prospects for repayment of these loans also became significantly worse. U.S. interest rates had risen markedly in nominal and real terms and, since most of the loans had either short maturities or variable interest rates, the effects were passed on to the borrower relatively quickly. By the time commodity prices had fallen almost 30 percent between 1980 and 1982, many governments in Latin America had already engaged in a spending spree that would render them incapable of repaying their debts. Even prior to Mexico's default in August 1982, one after one of these countries had experienced currency crises, banking crises, or both. When Mexico ultimately defaulted, the highly exposed and leveraged banks retrenched from emerging markets in general and from Latin America in particular. The result was the catastrophic debt crisis of the 1980s, a decade of economic stagnation in Latin America. The 1980s witnessed numerous crises in Latin America, including some of history's worst cases of hyperinflation outside of episodes of war. The drought in capital flows lasted until 1990.

Figure 2 shows net private capital flows for the contagion episodes of the 1990s, sharing with the previous figure the common pattern of a run-up in borrowing followed by a crash at the time of the initial shock and little or no borrowing thereafter.[3] In the case of Mexico, "this time it was supposed to be different," because Mexico had implemented a successful plan of inflation stabilization and linked its fate to the that of the United States through NAFTA. As the crisis loomed in 1994 (and

[3] Note that this phenomenon is not unique to emerging markets. Net private capital flows in the run-up to the ERM crisis in Europe had risen markedly and peaked in 1992 before coming to a sudden stop. A key difference was that in the advanced economies no defaults ensued.

FIGURE 2

Net Private Capital Flows, 1985–2003



1/ Includes Argentina and Mexico.
2/ Includes Indonesia, Malaysia, Philippines, South Korea, and Thailand.
Source: IMF, *World Economic Outlook.*

Note: If the crisis occurred in the second half of the year, the vertical line is inserted in the following year.

Mexico's credit rating was upgraded), capital flows were close to their 1992 peak after surging considerably, since as late as 1989 Mexico had overwhelmingly recorded net outflows. The rise in capital flows to Indonesia, Korea, Malaysia, the Philippines and Thailand (shown in Figure 2) was no less dramatic—especially after 1995, with the escalation of Japanese and European bank lending to emerging Asia. (Remember, of course, short-term interest rates in Japan were headed toward unprecedented lows.)

The bottom right panel of Figure 2 shows the evolution of capital flows to all emerging markets and the progression of crises. The halcyon days of capital flows to emerging markets took place during the first half of the 1990s, notwithstanding the Mexican crisis and its effects on Argentina. The eve of the 1996 Asian crisis (which was also "different," as it involved the East Asian miracle economies) marks the peak of the cycle, and Asia delivers the first blow from which there is no full recovery. Because total net flows include foreign direct investment (FDI),

which held up better than portfolio bond and equity flows, Figure 2 somewhat understates the extent of the sudden stop problem that emerging markets faced following the 1998 Russian crisis period. After a sharp reduction in capital flows to emerging markets during 1998–2002, spreads have narrowed to levels not seen since the early 1990s and even the pariahs (like Venezuela) are enjoying cheap access to international credit—perhaps investors have convinced themselves that President Chavez has managed to turn Venezuela into Singapore.[4]

In sum, the borrowing-crisis roller coaster is so established that there is even a cycle in the warnings about overborrowing. In 1927, for instance, the economic historian Max Winkler wrote:

> The over-abundance of funds, together with the difficulty of finding the most profitable employment therefore at home has contributed greatly to the pronounced demand for and the ready absorption of large foreign issues, irrespective of quality… . While high yield on a foreign bond does not necessarily indicate inferior quality, great care must be exercised in the selection of foreign bonds, especially today, when anything foreign seems to find a ready market… . Promiscuous buying, however, is destined to prove disastrous. (New York Tribune, March 17, 1927)

In 1929 a wave of currency crises that swept through Latin America was quickly followed by a string of defaults on sovereign external debt obligations. Charles Kindelberger and Carlos Diaz Alejandro, scholars who predicted the 1980s wave of defaults, were among Winkler's successors.

3. The "Latest" Debt Crisis, Debt Intolerance, and Serial Default

In this section, we discuss the ongoing debt crisis in Argentina, the concept of debt intolerance and therefore why "this time it's not different," and the attendant pattern of serial default that has characterized debt-intolerant countries.

The Latest Debt Crisis

After taming hyperinflation, modernizing its banks, and privatizing its enterprises, Argentina defaulted in 2001—its fourth sovereign default since independence. Argentina is not alone. Other countries, like Côte d'Ivoire or Ecuador, that had restructured their debt less than a decade ago under the aegis of the Brady Plan have also (yet again) defaulted or restructured their external debts.

[4] For more on this, see Rogoff (2004).

At present, besides those countries that have already defaulted or restructured, countries like Brazil, Lebanon, Turkey, and Venezuela (among several others) are now skirting the danger zone (in terms of their capacity to repay their debts in the years ahead). It thus appears that the prospect that debt crises will continue to be with us is almost a certainty. The "latest" debt crisis has not been quite as synchronized as the last one in the early 1980s. The dramatic domino effect that the sharp and sudden rise in real international interest rates to the range of 10 percent (the highest levels since the 1930s) produced is far from present. As noted earlier, unlike the early 1980s, international interest rates are remarkably low and alleviate the debt servicing burdens of debtor nations. High commodity prices are helping developing countries as well; indeed they have played an important role in Argentina's ability to temporarily grow in the shadow of its massive default. Unfortunately, judging from experience, such a favorable setting makes it all the more tempting for governments of developing countries to borrow too much and to wait too long to make the more fundamental adjustments need to achieve sustainability.

Debt Intolerance

Why is it that so little debt (by the standards of the industrialized nations, at least) can do so much damage to an emerging market economy, as well as to its political system and institutions? There are parallels in medicine. To the lactose intolerant, a small dosage of a dairy product can produce powerful adverse effects. When it comes to debt, emerging market countries seem to suffer from a similar malaise. "Debt intolerance" manifests itself in the extreme duress many emerging markets experience at debt levels that would be considered manageable by advanced country standards. As investors get jittery, credit lines are often abruptly cut and trade and economic activity are disrupted.

As shown in Reinhart, Rogoff, and Savastano (2003), "safe" levels of debt (where the risk of financial crisis and default is limited) for debt-intolerant countries are surprisingly low, perhaps as low as 15–20 percent of GDP in many cases. Moreover, those thresholds depend critically on a country's record of default and inflation. For example, inflation rates above 40 percent per annum have been commonplace among the most debt-intolerant serial defaulters. Simply put, governments with a history of serial default or chronic inflation should shy away from borrowing—irrespective of how attractive conditions may be at the present juncture.

Because so many emerging market countries are debt intolerant, it is worth noting that more than one-half of the default events in emerging market economies since 1970 took place at external debt-to-GNP ratios below 60 percent. In other words, crises and default unfolded at debt-to-GNP levels that would have satisfied Europe's Maastricht criteria. Thus, understanding the widespread and fundamental problem of debt intolerance is critical in assessing the problems of debt sustainability, debt restructuring, and the scope for international lending to ameliorate crises.

Serial Defaulters

As noted, serial default on external debt is pervasive and not new. Major European countries, which set benchmarks that today's emerging markets have yet to surpass, seem to have forgotten their own histories now that their institutions are creditors. For instance, as shown in Table 1, France used to default every thirty years or so during the period 1500–1800; Spain defaulted thirteen times between 1500 and 1900. Venezuela's nine postindependence defaults (Table 2) look tame by contrast. Graduation from serial default is neither quick nor easy, in part because safe levels of debt (that is, those that do not end in a default and a financial crisis) are remarkably low for serial defaulters. They are much lower than those for the advanced economies or for the emerging markets that have never defaulted—and usually involve overthrowing the old political regime.

TABLE 1

An Early History of External Debt Defaults: Number of Defaults

	1501–1800	1801–1900	1501–1900
Austria	n.a.	5	5
France	8	n.a.	8
Greece	n.a.	4	4
Germany	1	5	6
Portugal	1	5	6
Spain	6	7	13

Sources: Max Winkler (1933), "Foreign Bonds: An Autopsy," Philadelphia: Roland Swain Company, William Wynne (1951) "State Insolvency and Foreign Bondholders, Vol. II" New Haven: Yale University Press, and Jaime Vives (1969), "An Economic History of Spain," Princeton, NJ: Princeton University Press.

[a] "The age of financial pathology" (Winkler 1933, 35).

[b] Total for the period 1501–1800 only.

Notes: An n.a. denotes not available.

TABLE 2

External Debt Defaults in Emerging Markets, 1824-2001

	Number of Default or Restructuring Episodes	Percentage of Years in a State of Default or Restructuring	Number of Years since Last Year in Default or Restructuring Status
Argentina	4	26.1	0
Brazil	7	25.6	7
Chile	3	23.3	17
Colombia	7	38.6	57
Mexico	8	46.9	12
Philippines	1	18.5	10
Turkey	6	16.5	20
Venezuela	9	38.6	4
Group average	*5.2*	*27.4*	*16*

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Sources: Based on authors' calculations. Dates for the default or restructuring episodes are taken from Beim and Calomiris (2001) and Standard and Poor's *Credit Week* and *Debt Cycles in the World Economy* (1992); the ratings are from *Institutional Investor*, inflation is calculated from consumer price indices as reported in *International Monetary Fund*, International Financial Statistics.

4. Remedies for the Debt Intolerant and the Institutions That Deal with Them

So what policies should countries adopt and multilateral institutions endorse to avoid the problem of debt intolerance and serial default? First and foremost—there are no quick fixes. Graduation from the debt-intolerance club does not come quickly.

The Governments

The policy challenge for these countries is to address a chronic long-term problem—debt intolerance. Solutions do not lie in taking remedial measures that allow them to gain the favor of international capital markets for a few of months, or even years. At a very minimum, this means curbing the all-too-common tendency of governments to borrow in good times, when markets are all too willing to lend. The evidence that fiscal policies are procyclical is fairly compelling.[5] The fiscal restraint has to be consistent—a few years of good behavior simply will not do. Argentina's 2001 default is testimony to the need for fiscal restraint over the course of perhaps decades rather than years and for budget rules to discipline politicians. Lest we forget, Argentina's government showed

[5] For fresh evidence for 105 countries and a survey of the literature, see Kaminsky, Reinhart, and Végh (2004).

significant fiscal restraint in the early 1990s, at the time when it was fast becoming the poster child of the international community.

The fact that borrowing in most developing countries usually ends in a financial or debt crisis (or both) may owe to a vicious cycle (with origins that include but are beyond tarnished reputations) in which default weakens institutions and makes future defaults more likely. Hence, the need for policymakers in these countries to internalize the understanding that "safe" debt thresholds are country specific and depend importantly on history. Because of a weak institutional framework, "safe" external debt thresholds for highly debt-intolerant emerging markets appear to be surprisingly low, perhaps as low as 15–20 percent of GNP in many cases. And these thresholds depend heavily on the country's record of default and inflation. It is not unusual to find, for example, that most of the larger emerging markets that are most debt intolerant (such as Argentina, Brazil, and Turkey) have the worst inflation track records—with about a 50 percent chance that annual inflation will be above 40 percent! Debt-intolerant countries also tend to have weak fiscal structures and weak financial systems. Default often exacerbates these problems, making these same countries more prone to future default. Indeed, more insights are needed to shed light on what other factors (economic, political, and institutional) figure in the calculus of what debt levels are sustainable—both external and domestic—and what are the true long-term costs of defaulting.

The Myth: Countries Can "Simply Grow Out of Their Debt"

During "good times," when it is easy for governments to borrow liberally, the chronically deluded (or the opportunistic) will inevitably argue that borrowing is not a problem, as "this time" the country will grow out of its debts. Lamentably, however, there is little evidence to support such optimism. How, historically, have emerging market countries with substantial external debts managed to work them down? This is a phenomenon that has previously received surprisingly little attention. As Reinhart, Rogoff, and Savastano (2003) show, in episodes where external debt-to-GNP fell substantially over a three-year period, almost two-thirds involved some form of default or restructuring. Only in one case—Swaziland in 1985—was a country able to "grow" its way out of its debt.

The Multilaterals

As to the multilateral organizations, it is time to turn many of the popular criticisms on their head. The International Monetary Fund has been

vilified for the "austerity" of its programs (usually in crisis episodes). Such criticisms are often misplaced; as in times of crisis, for example, when capital flight is rife, there are few (if any) alternatives to austerity. Surprisingly, the IMF has not received sufficient well-deserved criticism for its complacency as countries pile up the debt "in the good years." (Michael Mussa's account of the run-up to the Argentine crises of 2001 is a notable exception.) If history offers us a clear and crisp lesson, it is that the seeds of debt crises are sown when the outlook is benign. It is in these good years that the IMF has shown a persistent inclination not to ruffle the feathers of member governments while heaping (often undeserved) praise on their economic program. The World Bank can often be even worse, as when just prior to the Asia crisis it released a report giving a clean bill of health to Indonesia's soon to be troubled banking system.

An example of the official communities' willingness to look the other way is manifest in its optimistic public statements about risks facing the European accession countries, some of which are sustaining significant fiscal and current account deficits combined with a nontrivial loss of international competitiveness. The official community continues to downplay risks in Brazil and Turkey, despite the fact that Brazil is experiencing only modest growth in the face of nearly ideal external conditions, while Turkey's debt still exceeds 85 percent of GDP.

It is fair to say, however, that it is usually during the good times that it matters little to governments whether the IMF chides them or not for taking advantage of the opportunity to borrow copiously. It is precisely then that the multilaterals have the least leverage over policies. After all, myopic governments will always find the perfect excuse in such circumstances: "this time it's different." As the history of serial defaults shows, however, it is usually the case that times are not different enough and the borrowing binge usually ends in tears.

Financial Architecture: The Big Picture

Virtually every international economist would agree that one of the major unanswered questions in the field is why capital does not flow from rich countries to poor ones. That, of course, is the title of a famous paper by Robert Lucas (1990), which is why it is often called the Lucas paradox.[6]

[6] A different and earlier explanation for the "paradox" of why capital does not flow from rich to poor countries that stresses capital market imperfections rather than human capital externalities as in Lucas can be found in Gertler and Rogoff (1989; 1990). For a discussion of this so-called paradox, see Reinhart and Rogoff (2004).

In attempting to fashion a practical resolution to the Lucas paradox, some researchers rely on the following chain of logic:

— Since capital flows are insufficient to pull up the capital stock of emerging market economies to industrial standards,
— it must be the case that emerging market economies borrow too little.
— Therefore, mechanisms must be found to let them take on more debt.
— Among those mechanisms encouraging debt issuance are collective action clauses (CACs).
— Therefore, CACs are useful.

The problem is that the second premise is a non sequitur. As shown by Reinhart, Rogoff, and Savastano (2003) and Reinhart and Rogoff (2004), emerging market economies do not borrow too little; rather, they borrow too much. A significant fraction of countries are debt intolerant because their weak political systems, unequal distributions of income, inconsistent rules of law, and narrow and volatile tax bases imply that they cannot reliably service debt. For a country with such problems, to borrow is ultimately to default. If a significant fraction of emerging market economies are debt intolerant, efforts to make it easier to borrow will end in tears because making it easier to borrow will make it easier to default. Moreover, such an emphasis on borrowing will distract from more important and lasting mechanisms that foster direct investment in countries where rates of return should be very high. Making progress on that front is a more difficult way of improving the legal and political infrastructure of the country and making balance sheets more transparent. That job is not being done quickly and will only prove itself useful over time.

5. Concluding Observations

But the fact that officials and staff of finance ministries and international financial institutions have been so focused on the sovereign debt restructuring mechanisms (SDRM) and collection actions clauses (CACs) may be an implicit criticism of the net contribution of the work on the international financial architecture. When asked about CACs, SDRM, and other financial architecture fixes, we suggest a simple answer: Any "solution" that relies on international securities lawyers to promote a welfare-improving change is necessarily overstated. At this writing, it is impossible to generalize from the very limited experience with sovereigns

issuing collective action clauses. Worrying about effects measured in basis points with sizable standard errors misses the larger point: Emerging market economies borrowed too much not too little, and helping them to borrow more may not be helping them.

This suggests that academics and officials may want to be humble in their ambitions for "fixing" the existing financial architecture. Some problems may be too big and too basic for the international community to solve. Why should we think that a problem that has existed for five centuries across several continents can be solved by the stroke of a pen? The only durable and reliable solution for countries that aim to emerge from debt intolerance is to achieve low debt levels (by growth and repayments if possible, by restructuring if necessary) and to maintain those low levels. The international community can be helpful by making it harder not easier for developing countries to use rich country courts to enforce loans.[7] And the official community needs to exercise more restraint in bailouts, so as not to exacerbate moral hazard and encourage and deepen the next cycle of imprudent borrowing.

[7] See Bulow and Rogoff (1990) and Rogoff (1999).

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